service too low relative to the price of the existing service, all customers will buy the new service, resulting in a revenue loss to the LEC. The Commission recognized this problem by allowing an exception to the fully distributed cost ceiling to control migration from an existing service to a new, lower-cost service.[105]

The Commission also recognized that a fully distributed cost ceiling discourages the introduction of high risk, high cost new services. Rather than remove the ceiling for these types of new services, however, the Commission permitted price cap LECs to request a "risk premium" on investment in an unusually risky new service.[106] The "risk premium," however, suffers from serious shortcomings. First, a LEC must make a detailed demonstration that it is undertaking a venture which would not be economically practical absent the risk premium.[107]

Second, the current "risk premium" allowance is too limited in scope. If the LECs are to have sufficient incentives to deploy new services, they should be allowed to price services to include earnings on expenses not included in the traditional cost showings. In developing and deploying new services, large portions of total cash outlays are treated as

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105 See Part 69/ONA Second Further Reconsideration Order, 7 FCC Rcd 5235 (1992), at para. 11 & n.18.

106 See Part 69/ONA Order, 6 FCC Rcd 4524 (1991).

107 See CC Docket Nos. 89-79, 87-313, Order released July 11, 1991 at paras. 42-44; NPRM at para. 75, and notes 113-14.

expenses. For example, significant expenditures are frequently required for research and development, product planning and marketing, and customer education and support services. In addition, new service development often requires significant software enhancements, which are also typically treated as expenses.[108] The amount of dollars booked to expense relative to capitalized dollars is much higher today than in the earlier, hardware-intensive era. Limiting earnings to capitalized investment dollars denies a "return" on these substantial one-time expenses. In short, LECs should be permitted to determine their own "risk factor" in pricing new services, and not be constrained by any mandated ceiling.[109]

There are a number of modifications to the Commission's new services rules for price cap LECs that will ensure that these rules advance the Commission's goals of encouraging innovation and setting reasonable rates.[110] These modifications include the following:

- the Commission should reduce the notice period to a maximum of 21 days;

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108 For example, upgrades in operating systems that must be implemented to effect technological upgrades in the network are generally treated as expenses.

109 NYNEX recognizes the need for special treatment of a subset of new services, such as those mandated by the Commission, which are relatively less competitive, have significant public policy implications and/or are offerings to LEC competitors (e.g., interconnection). The Commission has treated such services on a case-by-case basis in the past, and can continue to do so. However, the Commission should not allow special treatment of a few offerings to limit the flexibility needed for other offerings.

110 Baseline Issue 8b.

- eliminate the maximum price constraint on new services;
- retain the minimum price constraint based on direct costs, but permit such cost support to be treated as proprietary information; and
- eliminate other cost support data requirements such as overhead loadings, demand and revenue projections.

The Commission seeks comment on whether new services are available on an equal basis to all LEC customers, and whether the Commission should revise the LEC price cap plan to ensure the universal availability of new services.[111]

New services are made available to all customers by NYNEX whenever possible. Generally, LECs have every incentive to provide new services to all customers in order to grow revenues. However, not all services are demanded by all customers. Further, technological deployment will determine availability of some new services. Costs, funding capabilities, market demand and other factors must be taken into account when deployment is scheduled. The rules should not be revised to "ensure" universal availability of new services, particularly if that means the service cannot be offered unless it is available in all areas at the time of the initial offering. This would delay introduction to customers in initial deployment areas and would not be in the public interest.

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111 Baseline Issue 8c.

7. The Balanced 50/50 Common Line Formula Should Be Retained

The Commission has also requested comment on several issues relating to common line charges.[112] Specifically, the Commission has asked whether it should reconsider its use of the balanced 50/50 formula to cap common line charges, and, if so, what method should be used to cap common line charges. The Commission also asks, if it were to adopt a per-line charge, how this would affect possible changes in the productivity factor or the composition of baskets.

In the LEC Price Cap Order, the Commission noted that developing a price cap formula for common line rates presented a unique problem because of the important social goals and programs embedded in those rates.[113] The Commission considered two possible formulas for capping common line rates. One formula would have capped a total common line rate per minute. The carrier common line ("CCL") rate would then have been computed as the difference between the common line rate per minute and the end user rate per minute. The other formula considered was a per-line formula under which all growth in minutes per line in one year would be applied to reduce the maximum CCL rate in the next year.[114] Under this proposal, LECs would have benefitted from any productivity gains derived from reducing average costs per line, but not

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112 Baseline Issues 5 a - d.

113 LEC Price Cap Order at para. 56.

114 Id. at para. 59.

from any increase in usage per line. The formula adopted by the Commission combined some features of each of these methods. Known as the "balanced 50/50 formula", it divided the benefits of increased per line usage of common line between the LECs and the interexchange carriers.[115] The Commission described the formula as a "compromise" in recognition of the fact that demand growth over common lines is, in substantial part, outside the LECs' control.[116]

The balanced 50/50 formula should be retained. The formula has produced significant downward pressure on CCL rates. During the time that price caps have been in effect, NYNEX's average effective premium CCL rate has declined from .00853 cents per minute of use to .00603 cents per minute of use, an effective annual decrease of approximately 11%.[117] The decline in CCL prices has been achieved despite the fact that minutes-of-use have grown at an annual rate of only 5%, and end user lines have grown at a rate of only 1.6%.

The Commission should not adopt a per-line common line formula. A per-line formula for common line has two major flaws. First, it would eliminate the incentives to the LECs provided by the balanced 50/50 formula. With a per-line

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115 Ibid.

116 Id. at para. 60.

117 The .00603 cents per minute rate and the 11% decline are based on an estimate of the removal of the General Support Facilities ("GSF") exogenous cost shift from the CCL rate development. The GSF shift increase was removed since the common line exogenous cost increase was exactly offset by decreases in the switched traffic sensitive and special access baskets.

formula, LECs would be incented to focus on cost reduction rather than on network upgrades and new services deployment. Moreover, a change to a per-line formula would also require modification of the productivity factor. All of the studies used to determine productivity utilize data reflecting minutes-of-use growth in the common line category. Conversion to a per line formula would require reduction of the productivity factor by at least .5%.[118]

There are a number of modifications that should be made to the CCL rate development process. First, the Commission should simplify the common line rate development process by modifying the rules governing end user charges. Specifically, the rules should be changed to provide for the use of historical, rather than forecasted revenues in the development of the base factor portion, which determines the end user charges. Use of historical demand, which is the basis for rate development for all other price cap rates, would simplify the rate development process for the LECs.

Furthermore, with the growth of competition, the Commission should permit price reductions below the maximum level produced by the CCL formula by class of service and geographic area, and allow use of the revenues from these price reductions to either establish a flat rated usage rate, or to increase other rates, subject to appropriate constraints, in

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118 In the initial price cap proceeding, the amount of productivity factor attributable to common line was estimated at .51%.

other service categories.[119] The Commission should also remove NECA Long-Term Support ("LTS") from CCL rate development, and permit "bulk-billing" of LTS directly to the IXCs.

8. Regulations Between LECs and CAPs Should Be Equalized

The Commission also requests comment as to whether regulations between LECs and CAPs should be equalized.[120] Specifically, the Commission requests comment as to whether the current rules for computing AT&T's exogenous access costs should be revised to equalize the treatment of LEC and CAP access rates in the calculation of AT&T's exogenous access costs. The Commission also asks whether any other rules or policies that relate to LEC price cap regulation should be revised to equalize treatment of LECs and CAPs.

The Commission should revise its rules to equalize the treatment of LEC and CAP access rates in the calculation of AT&T's exogenous access costs. Under the current rules, reductions in LEC access charges to AT&T are treated as exogenous costs and result in an adjustment to the AT&T price cap indices. As a result, AT&T is required to pass these reductions on to their customers as rate reductions. If AT&T obtains access to the local exchange network through a CAP, AT&T is not required to flow any expense reductions through to

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119 Increases would be limited to a fixed percentage, consistent with the other price cap baskets.

120 Baseline Issues 9a and 9b.

their customers, providing AT&T with an arbitrary regulatory incentive to purchase access from CAPs. With switched transport expanded interconnection, the Commission's rules will provide AT&T with further uneconomic incentives to obtain access from CAPs. All access costs should be treated equally under the Commission's rules in order for all customers to receive the benefits of lower access rates.

Regulatory parity in the treatment of LECs and CAPs should be adopted in a number of additional areas. The Commission should eliminate the sharing requirement which is imposed only on the LECs. With the sharing mechanism, price cap LECs must reduce their prices in the form of refunds when earnings exceed price cap thresholds. The LECs' competitors, including not only CAPs, but also IXCs such as AT&T and MCI, are not burdened with such restrictions.

Furthermore, the LECs must be afforded increased pricing flexibility. LECs in general, and NYNEX in particular, are facing significant competition from CAPs, IXCs and cable companies. Those competitors, however, have significantly greater flexibility in pricing their services than do the LECs.[121] The Commission should, therefore, grant the LECs increased pricing flexibility along the lines suggested by USTA.

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121 For example, the Common Carrier Bureau recently rejected a LEC tariff revision that would have allowed ICB pricing in response to customer requests for proposals. The proposed tariff mirrored a CAP's tariff language which had already been accepted by the Commission. See Southwestern Bell Telephone Company, Revisions to Tariff F.C.C. No. 73, Transmittal No. 2297, DA-94-204, Order, released March 4, 1994.

The Commission's disparate tariff requirements also place LECs at a serious competitive disadvantage. CAP competitors are permitted to file tariffs on one days' notice, without any cost support. LECs, on the other hand, must file their tariffs on as much as 45 days' notice and must include cost data with those filings, particularly new services filings.

The Commission's rules also permit the LECs' competitors to file "reasonable ranges of rates", while LECs must file tariffs containing the precise rate charged for each of their services. As NYNEX has demonstrated,[122] the Commission's rule permitting nondominant carriers to file a range of rates violates the Communications Act, and should be eliminated. In the event the Commission's decisions are upheld on appeal, the same flexibility should be extended to the LECs. Only if the regulations governing all telecommunications providers are equalized will customers realize the full benefits of competition.

9. The Commission's Current Service Quality Monitoring Regulations Should Not Be Modified

The Commission seeks comment on whether it should increase or revise the monitoring of the LECs' network reliability, service quality and infrastructure development.[123] The Commission currently has in place a comprehensive regime to monitor network reliability, service

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122 See *Tariff Filing Requirements for Nondominant Common Carriers*, CC Docket No. 93-36, Comments of the NYNEX Telephone Companies, dated March 29, 1993.

123 Baseline Issue 7a.

quality and infrastructure development. The Commission's requirements have been significantly expanded during the last three years and now comprise a highly detailed, complex and costly system. There is no need to expand these requirements further.

In the LEC Price Cap Order, the Commission expanded its rules by requiring quarterly service quality monitoring and infrastructure reports, as well as a revised and expanded semi-annual service quality report.[124] Since that time, the Common Carrier Bureau (the "Bureau") has further expanded those reporting requirements to include, among other things:

- the separation of installation and repair intervals into interexchange access versus local service, thereby requiring an additional table of data input;
- separate residence and business data;
- separate categories for Urban and Rural (Metropolitan Statistical Area [MSA] and non-MSA) data;
- switch downtime to be accumulated into 5,000 line increments;
- switch outages of 2 minutes or more to be individually identified;
- the identification of scheduled versus nonscheduled outage events; and
- a breakout of Federal and State complaints.[125]

The Commission has also adequately provided for oversight of network integrity. Specifically, the Commission has promulgated rules requiring carriers operating switching or

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124 LEC Price Cap Order at para. 335.

125 Policy and Rules Concerning Rates for Dominant Carriers, 6 FCC Rcd 2974 (1991).

transmission facilities to initially notify the Commission within 90 minutes if they experience service outages potentially affecting 50,000 or more customers and lasting 30 or more minutes.[126] A detailed report on the outage is required from the carrier within 30 days of the incident, and all such reported outages are fully investigated by the Commission.

Furthermore, the Commission created the Network Reliability Council ("NRC") to act as a Federal advisory group on network reliability in order to provide industry solutions to minimize public telephone network outages.[127] The NRC has held industry symposiums and focus groups and has submitted reports to the Commission detailing "best practices" in this area. As recently as December 1, 1993, the Commission released a Memorandum Opinion And Order and Further Notice of Proposed Rulemaking to adopt many of the proposals of the NRC.[128] The ongoing efforts of the Commission and industry groups in the pursuit of service quality, infrastructure reporting and network reliability make it unnecessary at this time to

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126 <u>Service Outage Order</u>, 7 FCC Rcd 2010 (1992); <u>see</u> Section 63.100 of the Commission's Rules, 47 C.F.R. Section 63.100.

127 <u>See</u> FCC News Release (December 13, 1991).

128 For example, it is now proposed to have service outages potentially affecting 30,000 or more customers initially reported to the Commission within 3 days, with the final report due within 30 days.

incorporate any further measures to expand the reporting processes.[129]

Moreover, competition will require that LECs maintain high service quality levels. Without a high service quality level, customers will turn to a competitive supplier.

The Commission also invites comments whether, and if so how, it should expand its service quality monitoring to include Price Cap LEC facilities and services that may be interconnected with the local exchange network or used to provide similar services, including wireless services and coaxial cable.[130] It is premature to prescribe service quality monitoring requirements for services or facilities that have yet to be deployed. Once implementation has occurred, the Commission and the industry will be in a better position to determine exactly what areas of the service need to be monitored, and more importantly, how performance can be improved.

Finally, the Commission suggests that potentially uneven development of local exchange access competition may lead to "[i]nner cities, rural areas, and the less well-off... see[ing] fewer benefits from competition, or even declines in service quality".[131] The Commission asks whether it should

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129 The work of the NRC has recently been assumed by the Network Reliability Steering Committee of the Alliance for Telecommunications Industry Solutions, which monitors the major outages of all telecommunications carriers in the country.

130 Baseline Issue 7b.

131 NPRM at para. 98.

revise its monitoring of LEC service quality, network reliability, and infrastructure as part of any transition plan.[132]

During the period that price caps have been in effect, local exchange access competition has intensified in the NYNEX region. Nevertheless, there is no indication that service quality has declined in geographic areas where competition is less intense. Currently, data is reported to the Commission based on an MSA and non-MSA basis, which is roughly equivalent to an urban/rural split. The Commission has noted that its

> ... review of submitted data reveals no indications of degraded service or of increased need for detail. Continuing high service quality means that increased disaggregation of these data would place on the filing carriers and on Commission resources a burden that could not be justified. We continue to believe, and the data collected so far confirm, that the existing high level of service quality and the LECs' response to price cap incentives negate any need for disaggregated reporting or the establishment of national standards.[133]

Accordingly, no revisions in the Commission's current monitoring system are warranted.

10. <u>The FCC Should Not Reduce The Number Of Cost Changes Eligible For Exogenous Treatment Under Price Cap Regulation</u>

The Commission invites comment on whether to reduce the number of cost changes currently eligible for exogenous

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132 Baseline Issue 4.

133 AAD 92-47, October 12, 1993 Order at para. 12.

treatment under price caps.[134] The rules currently provide for an adjustment to the PCI to reflect certain costs incurred by LECs caused by "administrative, legislative or judicial requirements beyond the control of the carrier".[135] The Commission's rationale for recognition of exogenous costs is to avoid "unreasonably high or unreasonably low rates" that could otherwise result from ignoring such cost changes, and merely "treating them as changes in the carrier's level of efficiency".[136] In this way, the Commission seeks to avoid "unjustly punish[ing] or reward[ing] the carrier".[137] NYNEX believes that the current rules should be retained. As discussed below, there is no basis for curtailing the allowability of exogenous costs.

NYNEX, however, seeks clarification of the Commission's characterization of exogenous treatment rules pertaining to changes in Generally Accepted Accounting Principles ("GAAP"). The Commission states that:

> we decided to accord exogenous treatment to GAAP changes (which have been adopted by the Financial Accounting Standards Board and have become effective) only if the costs are neither within the control of the price cap

134 NPRM at para. 66, Baseline Issues 6 a-c.

135 Id. at para. 60.

136 Id.

137 Id. Examples of cost changes eligible for exogenous treatment are set forth in Section 61.45(d) of the Commission's rules.

> carriers nor reflected in the price cap formula.[138]

The Commission's language could be read to mean that having some control over costs underlying GAAP changes will preclude exogenous treatment. NYNEX requests that the Commission confirm that it will interpret its rules to require lack of control over the incremental cost change event, not lack of control over the level of the underlying costs themselves. This area has been argued in the context of the FCC-mandated change from cash to accrual accounting for OPEBs.[139] Nevertheless, we will briefly summarize our position here for the record. In short, prior to its OPEB Order which is under judicial review, the Commission had indicated that near-automatic exogenous treatment would be accorded to Uniform System of Accounts ("USOA") or GAAP changes that have been approved by the FASB and Commission for accounting purposes, are effective, and will not be double-counted in the GNP-PI factor in the price cap formula.

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138 Id. at para. 62. (Emphasis supplied) See also NPRM at para. 63 ("[LECs] should not be held responsible for cost changes that were not of their choosing, were out of their control....")

139 Treatment Of Local Exchange Carrier Tariffs Implementing Statement Of Financial Accounting Standards No. 106, Employers Accounting For Postretirement Benefits Other Than Pensions, 8 FCC Rcd 1024 (1993), petitions for review pending sub nom. Southwestern Bell Tel. Co. v. FCC, D.C. Cir. No. 93-1168. ("OPEB Order") In that proceeding, NYNEX and other petitioners seek exogenous treatment for the one-time incremental cost change attributable entirely to SFAS-106 and the Commission's implementation mandate, a change which was beyond the carriers' control.

First, USOA changes are specifically listed in Commission Rule 61.45(d)(i)(ii) as eligible for exogenous treatment. Second, in various Orders, the Commission has indicated GAAP changes are to be treated the same as USOA changes for purposes of exogenous treatment. As the Commission has stated, "there is no difference in principle between a cost change caused by a USOA change and a cost change caused by a GAAP change."[140] Third, the Commission highlighted the substantive equivalence of USOA and GAAP changes by observing that "[a] change in accounting treatment may produce substantial changes in carrier costs and, like jurisdictional separations, is imposed by this Commission."[141] Fourth, the Commission has explicitly indicated that USOA/GAAP changes will be accorded exogenous treatment where: (1) the FASB has approved the change and it has become effective; (2) the Commission has approved the change for regulatory accounting;[142] and (3) "the change will not be adequately reflected in the GNP-PI."[143] Accordingly,

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140 Policy And Rules Concerning Rates For Dominant Carriers, 4 FCC Rcd 2873, 3017 (1989). See also AT&T, Revisions To Tariff F.C.C. Nos. 1, 2 and 13, 5 FCC Rcd 3680, para. 4 (1990) (Section 61.44(c)(2), which applies to AT&T, is the counterpart of Section 61.45(d)(ii), which applies to LECs): "Section 61.44(c)(2) exogenous costs can be either cost changes resulting from a change in [Commission] accounting rules or in any Commission-approved change in GAAP."

141 Policy And Rules Concerning Rates For Dominant Carriers, 3 FCC Rcd 3195, 3424 (1988).

142 LEC Price Cap Order, 5 FCC Rcd 6786, 6807 (1990).

143 AT&T Price Cap Reconsideration Order, 6 FCC Rcd 665 (1991); see also LEC Price Cap Reconsideration Order, 6 FCC Rcd 2637, 2665 (1991).

the Commission has never conditioned exogenous treatment of GAAP changes on lack of control by the LEC over underlying costs, and the Commission should not adopt such a requirement in this proceeding.[144]

Moreover, permitting exogenous treatment of GAAP changes is entirely consistent with the incentive-based nature of price cap regulation. Carriers have no control over the GAAP change nor over the fact that an incremental cost change is triggered. To the extent the quantification of the level of costs is at issue, the Commission can assure conservative approaches are taken to assure just and reasonable rates. After the exogenous event, carriers will continue to have every incentive to contain costs and improve efficiency in order to meet or exceed the productivity factor.

Furthermore, it would be patently unfair to scale back recognition of exogenous costs. Under the current price cap rules, several exogenous adjustments have been completed since the January 1, 1991 introduction of price caps.[145] These exogenous adjustments provided for substantial downward adjustments in the price cap indices of LECs. In fact, the

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144 The Commission could not have intended that having some control over the level of underlying costs will render a cost item ineligible for exogenous treatment. Such an approach would essentially negate all items eligible for exogenous treatment, making Section 61.45(d) a nullity.

145 These adjustments include separations changes, completion of depreciation reserve deficiency amortization, and completion of inside wire amortization.

combination of exogenous and other price cap adjustments have resulted in significant reductions in access rates.[146]

If the allowable exogenous adjustments were curtailed, the Commission would have ensured that all large downward adjustments had been completed, but might limit provision for the completion of the Excess Deferred Taxes/Investment Tax Credit changes (which can provide for relatively small upward adjustments) or other unforeseen adjustments. This would be inequitable for the price cap LECs. Unforeseen adjustments could be imposed by state regulatory or legislative actions, meet the definition of being outside the LECs' control, and also be unrecoverable in the GNP-PI index. In such cases, if exogenous treatment were not allowed, LEC efficiencies would be required to offset such uncontrollable expenses. The basic premise that price caps was to provide incentives for LECs to

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146 In the filing effective January 1, 1991 initiating price caps, price cap LECs' access rates were reduced by approximately $342 million. In the 1991 annual filing, access rates for Price Cap LECs were reduced by approximately $486 million, and in the 1992 annual filing, Tier 1 LECs and the National Exchange Carrier Association (NECA) filed access rate reductions of $463 million. The Commission then ordered an additional $32 million reduction in access rates for price cap LECs. For NYNEX, the tariff revisions effective January 1, 1991 resulted in a $48 million decrease in access rates. The 1991 annual filing resulted in a negative revenue effect of approximately $68 million, and the 1992 annual filing resulted in a decrease of approximately $24 million. The 1993 annual filing resulted in access rate decreases of $95 million. The remaining exogenous adjustments under existing rules are the flow-back of Excess Deferred Taxes and Investment Tax Credits, reallocation of investment from regulated to nonregulated use, sharing and lower formula adjustments, NECA support payment changes, and other adjustments that the Commission permits or requires.

achieve and benefit from improved efficiencies would be lost.[147]

The Commission also requests comment on "whether we should narrow exogenous treatment of GAAP and USOA changes, for example by limiting eligibility for exogenous treatment to economic cost changes."[148] The Commission states:

> ... a GAAP change may represent only a change in how books are kept and costs are recorded, not an economic cost change that might be expected to affect prices in competitive marketplaces.... In the economy generally, one expects that accounting changes alone will not affect market-based prices.[149]

Exogenous treatment of GAAP and USOA changes should not be narrowed. The treatment of exogenous cost changes should not depend on a distinction between accrual versus cash basis accounting. The Commission implicitly accepted the economic recognition of accruing OPEB costs when it ordered SFAS-106 to be reflected in regulatory accounting.[150] The

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147 Additionally, the LECs entered price caps with the understanding that exogenous adjustments would be part of the LEC plan. For the RBOCs, this plan influenced their comments and positions in the original price cap proceeding, and for other LECs it influenced their decision to select price cap regulation. Changing this major component of the LEC price cap plan now would place an unfair burden on LECs.

148 NPRM at para. 64.

149 Id.

150 See OPEB Order. Exogenous treatment furthers the matching principle; that is, as ratepayers benefit today from employees' services, those same ratepayers should also pay for the OPEBs earned by those employees that are accounted for as current expenses pursuant to SFAS-106.

fact that costs are accrued does not make them any less real — that the FASB and the Commission require those accrued costs to be currently recognized underscores their economic significance. The accrual approach will impact timing of cost recognition and cash flow. The costs must still be recovered in "market-based" prices.

Moreover, the benefits that are possible under price caps would be severely undermined if the Commission disallowed certain costs under price caps that were allowed under rate of return regulation, such as depreciation, pensions or taxes, based solely on the fact that they were accounted for on an accrual basis.[151] The Commission has previously observed that "[a] change in accounting treatment may produce substantial changes in carrier costs" and likened such changes to jurisdictional separations changes,[152] which are clearly allowed as exogenous adjustments.[153]

It bears emphasis that the Commission decided to impose exogenous treatment for the expiration of reserve deficiency amortizations ("RDAs") which were not accounted for on a cash basis and were what might be viewed as "a change in

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151 The FCC allowed initial price cap rates to go into effect reflecting incremental pension costs occasioned by the SFAS-87 change to accrual accounting. See U S West And NYNEX Requests To Implement New Pension Accounting For Calendar Year 1987, 2 FCC Rcd 2464 (1987).

152 Price Cap Further Notice, 3 FCC Rcd 3195, 3424, (1988).

153 See 47 C.F.R. § 61.45(d)(1)(iii).

how books are kept".[154] The expiration of RDAs resulted in downward adjustments in price cap indexes. To require such adjustments for downward changes, but not allow them for upward changes, would be patently unfair.[155]

The Commission also solicits comment on "whether only cost changes that solely affect telephone companies or similar companies such as utilities should be eligible for exogenous cost treatment".[156] NYNEX believes that such a limitation is unwarranted.

First, if the Commission were to curtail exogenous cost allowances, price cap LEC shareholders would have to bear cost changes outside their control. This would be contrary to price cap policy which seeks to avoid penalizing or rewarding carriers by treating such changes as changes in the carriers' level of efficiency. Second, exogenous changes thus far have produced significant rate decreases. Third, some GAAP-type changes may increase revenue requirements, while others may decrease them. Since the FASB's GAAP changes are well-publicized and industry-wide, and are automatically incorporated into the Commission-prescribed regulatory USOA (absent the Commission's contrary determination), there is no ability for carriers to "pick and choose" GAAP changes based on

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154 See NPRM at para. 60.

155 Finally, there is no evidentiary basis for the Commission's suggestion that accounting changes will have no impact on competitive pricing. Moreover, this consideration has not been relevant to past exogenous treatment nor should it be relevant in the future.

156 NPRM at para. 65.

rate effects. Fourth, as for quantification of the level of cost changes, the Commission has the expertise to regulate the amount of the adjustments to assure just and reasonable rates. Finally, there is no evidence that carriers have sought only upward exogenous adjustments. NYNEX and other carriers have filed for downward exogenous adjustments, and interested parties are readily able to propose such adjustments as well.[157]

Finally, the Commission asks whether it should adopt an administrative process to allow third parties to request cost changes eligible for exogenous treatment.[158] There is no need to adopt a new administrative process to allow access customers to request cost changes eligible for exogenous treatment. Exogenous cost changes under price cap rules are part of the rate setting process. Thus, parties can file petitions to suspend or reject, opposing or proposing exogenous adjustments. Parties can also make similar filings in the context of rate investigations, and access customers can and do utilize the formal complaint process relative to access charges. Moreover, parties can always file a petition for declaratory ruling or a motion to press their positions relative to exogenous cost changes.

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157 For example, NYNEX has included a downward exogenous adjustment for the four year phase out of a Central Office Equipment property tax in New York.

158 Baseline Issue 6c.

11. GDP-PI Should Be Substituted for GNP-PI as the Measure of Inflation in the Price Cap Formula

The Commission asks whether it should adopt revisions to the LEC price cap plan in addition to those discussed in the NPRM.[159] NYNEX recommends that the Commission substitute the gross domestic product-price index ("GDP-PI") for the gross national product-price index ("GNP-PI") as the inflation measure in the price cap formula. This change will reduce administrative burdens on price cap LECs while continuing to provide a reliable measure of inflation.

Both the GDP-PI and GNP-PI are recognized measures of inflation, with only minor differences in methodology.[160] As a result, there has been only a very slight difference in the results of these two measures over time.[161] The use of GNP-PI as the inflation measure for the price cap formula, however, creates administrative burdens for the LECs. Beginning in 1991, the U.S. Department of Commerce discontinued publication of the 45-day estimate of the GNP-PI, substituting a 45-day estimate of the GDP-PI. While the Commerce Department continued to publish a 75-day estimate of the GNP-PI, that estimate has not been released in time for incorporation in the

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159 NPRM at para. 90, Baseline Issue 11.

160 The GNP-PI measures the total value of goods produced by U.S. firms. The GDP-PI excludes from this measurement the value of goods produced abroad by U.S. firms.

161 For example, since 1982, GNP-PI and GDP-PI measures of national inflation have grown at average annual rates of 3.65 and 3.66 percent, respectively. See NERA Study at p. 13.

price cap LECs' annual access tariff filings. As a result, most LECs now use the 45-day GDP-PI estimate in their annual access tariff filings and are then required to make an insignificant, but administratively burdensome "true-up" to reflect the 75-day GNP-PI estimate. Use of the GDP-PI would eliminate this unnecessary administrative burden.

12. The Price Cap Plan Should Include Further Capital Recovery Reform

There is an urgent need for revised capital recovery rules for LECs. While significant relief was recently granted to AT&T,[162] only minor changes were made in the depreciation rules applicable to the LECs.

Depreciation reform is urgently needed in order for the LECs to help develop the National Information Infrastructure envisioned by the Clinton Administration. In order for this vision to become a reality, the LECs will require adjustments to their depreciation rates based on equipment lives which better reflect the technological and competitive environment in which the LECs operate. LEC competitors and many other regulated communications companies use depreciation lives one-half to one-third those of NYNEX for similar or identical equipment.[163] The legacy of these

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162 See Simplification of the Depreciation Prescription Process, CC Docket No. 92-296 Report and Order, released October 20, 1993.

163 For example, in 1991, AT&T's Commission-prescribed composite depreciation rate was 13.8%, while NYNEX's was 7.0%. (See 1991 Form M Reports for AT&T and NYNEX.) U.S. cable and cellular companies depreciate

(Footnote Continued On Next Page)

overly long depreciation schedules has left NYNEX with the burden of attempting to recover the depreciation shortfall from old equipment while, at the same time, establishing the proper level of recovery for investment in newer technologies. Continuation of this practice of under-depreciation in an increasingly competitive market sends a clear signal to investors that there is a risk of not recovering investments made in NYNEX.

Furthermore, by allowing the LECs to initially set their own depreciation rates in a streamlined prescription process, the Commission will require the LECs to accept fully the risks involved in investment decisions and their associated depreciation and amortization schedules. If the Commission continues to closely regulate depreciation rates, it will effectively be regulating earnings. Such an approach, like the sharing mechanism, seriously dilutes the incentives built into the price cap plan, and must be modified.

13. The Price Cap Review Intervals Should Be Lengthened

The Commission has asked for comment concerning when the LECs' price cap performance should next be reviewed.[164] The Commission suggests that it might be necessary to review

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163 (Footnote Continued From Previous Page)

fiber cable over 5-15 year lives, while the range for Commission-regulated LECs is 25-30 years. (*See* CTM Report, Tables 5.4, 5.7-5.9; CC Docket No. 92-296, Order inviting Comments released November 12, 1993, Appendix.)

164 Transitional Issue 5.